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No.

Supreme Court, U. S.
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IN THE

# Supreme Court of the United States

72-230

~~M. LLOYD FREESE and~~ DOROTHY M. FREESE, EXECUTRIX ETC.
**Petitioners**

VERSUS

**UNITED STATES OF AMERICA**
**Respondent**

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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**M. LLOYD FREESE and DOROTHY M. FREESE**
**Petitioners**

VERSUS

**UNITED STATES OF AMERICA**
**Respondent**

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

To the Honorable Chief Justice and
Associate Justices of the Supreme Court
of the United States:

The Estate of M. Lloyd Freese and Dorothy Freese, the petitioners herein, pray that a writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Tenth Circuit entered in the above entitled cause on February 23, 1972.

## A. OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit has been reported in 455 F. 2d 1146 and is printed in Appendix A hereto at page A-25. The Findings of Fact, Conclusions of Law, and Judgment of the United States District Court for the Northern District of Oklahoma is printed in Appendix B hereto at page A-42.

## B. JURISDICTION

The Judgment of the Court of Appeals was entered on February 23, 1972. Petitioners' Petition for Rehearing was denied on April 10, 1972. Additional time for filing this Writ of Certiorari was granted to August 8, 1972. The jurisdiction of the Court is invoked under 28 U.S.C. Sec. 1254 (1).

## C. QUESTIONS PRESENTED FOR REVIEW

1. Was the refusal of the Trial Court to allow the testimony of witness Shakely in direct violation of the tests set forth in *Culbertson v. United States*, 337 U.S. 733 (1949) at 743, for determining whether a partnership relationship exists? Shakely was a disinterested third party who would have testified as to the representations of the contracting parties to the public and to business associates.

2. Was the determination that Freese was only a creditor of Bell Oil & Gas Company contrary to the con-

trolling law of debtor-creditor relationship. Leaving money with a company at risk, subordinated to all creditors, not evidenced by a note, not bearing interest, subject to being reduced or increased by a percentage of the profits or losses, and to be repaid only when stockholders were paid dividends, is an investment and does not create a debtor-creditor relationship.

3. Did Freese sell a joint venture interest in 1965?

## D. STATUTES INVOLVED

Since the statutes and regulations involved are lengthy, only their citations and pertinent text is herewith set forth.

Reg. Sec. 1.166-1

"* * * a bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. * * *"

Sec. 385 (1969 Codification of prior law)

"(b) FACTORS. The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate

consideration in money or money's worth, and to pay a fixed rate of interest,

(2) Whether there is subordination to or preference over any indebtedness of the corporation,

(3) The ratio of debt to equity of the corporation,

(4) Whether there is convertibility into the stock of the corporation, and

(5) The relationship between holdings of stock in the corporation and holdings of the interest in question.

Sec. 7701

"(a) (2) Partnership and partner.—The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."

Reg. Sec. 301.7701-1 (c)

"Similarly, the term 'partnership' is not limited to the common-law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships."

Reg. Sec. 301.7701-3 (a)

"(a) In general.—The term 'partnership is broader in scope than the common law meaning of partnership and may include groups not commonly called partnership. Thus, the term 'partnership' includes a syndicate, group, pool, joint venture, or other unin-

corporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954.

## E. STATEMENT OF THE CASE

The issue here is whether M. Lloyd Freese (hereafter referred to as Freese) sold in 1965 a joint venture interest in Bell Oil & Gas Company (hereafter referred to as Bell).

The lower court held that Freese was only an employee and a creditor of Bell. Your Petitioners contend that under the facts in this case Freese had to be a joint venturer. The facts are not in dispute, the legal conclusion is! As the Tenth Circuit stated, a review of historical relationship of the parties is important.

In 1926 Freese and others contracted with Bell to construct a cracking plant at Grandfield, Oklahoma. (Vol. II, pg. 210-218). This contract spelled out the profit and business motive of the parties, as follows:

> " * * * thereafter a corporation shall be organized * * * and *each of said parties to receive* * * * *one-half of the total authorized and issued capital stock of such corporation.*" (App. Vol. II, pg. 216-217).

Two years later the new corporation (Altitude Petroleum Corporation) was formed. Bell held all the stock, but Freese's contract with Bell provided for a salary

(App. Vol. II, pg. 223), management responsibility (App. Vol. II, pg. 222, 225), participation in profits and losses (App. Vol. II, pg. 223), and the right to acquire 25% of the authorized stock of Altitude Petroleum Corporation (hereafter referred to as Altitude) (App. Vol. II, pg. 225). Though the contract was silent, the stated intent of the interest in profits and losses was:

> "• • • • I want to state that all physical assets such as the former Peerless Refinery at Chanute, should we purchase same the Operators Oil Company's Oklahoma City pipeline, and whatever else we purchase for Altitude will be the property of the Altitude; *but, of course, both of you will own your share of the physical assets, not only the profits and losses.*" (App. Vol. II, pg. 174, 175).

In 1934, *Freese, by contract acquired a 25% interest in the Bell Marketing Department and* Altitude was liquidated into Bell Marketing Department. (App. Vol. II, pg. 35, 233-247)

Freese's *initial investment* in Bell Marketing Department was *$15,000 cash*. (App. Vol. I, pg. 57) (App. Vol. II, pg. 1). Additional funds thereafter were invested with Bell (App. Vol. II, pg. 43, 99). Under this contract with Bell, *Freese was to manage Bell Marketing Department*. (App. Vol. II, pg. 38, 222). Freese had the right to *approve or disapprove any charges made by Bell against its Marketing Department* (App. Vol. II, pg. 224) and he did in fact exercise those rights. (App. Vol. I, pg. 83, 91) (App. Vol. II, pg. 48, 49, 284) (Pl. Ex. 44)

*Freese was to draw a small salary, $800, but further was entitled to 25% of net profits out of the Marketing Department.* (App. Vol. II, pg. 236). It is emphasized that *Freese was individually and personally liable for 25% of all losses* of Bell Marketing Department. (App. Vol. II, pg. 237). By contract all monies invested in the Marketing Department by Freese and Bell bore 6% interest. (App. Vol. II, pg. 38, 235, 249, 250) Freese was to be Vice President of the Marketing Department for the life of the contract. (App. Vol. II, pg. 38, 239). Freese further was entitled to a fee for services rendered to Bell by Freese outside the Marketing Department and did in fact receive fees. (App. Vol. II, pg. 184). *Freese* had the right, *on termination* of the contract to liquidate the Marketing Department and *receive 25% of the assets in kind.* (App. Vol. II, pg. 245).

Between 1934 and February 31, 1938, Freese had invested in Bell and its subsidiaries cash of $66,386.17. (App. Vol. I, pg. 58, 63) (App. Vol. II, pg. 4, 268, 269). The books and records and financial statements of *Bell showed this investment on the capital section of its Balance Sheet as Equity in Bell Oil & Gas Company and subsidiaries.* (App. Vol. I pg. 59, 63) (Vol. II, 188, 191, 269, 286, 289) (Pl. Ex. 33, Schedule 2; Pl. Ex. 34, Schedule 2).

Though Freese was not shown as a stockholder of record Bell told Freese that he in effect had the rights of a stockholder.

"• • • • it is understood that you will have your share of the undistributed profits of this corporation as well as your respective interest in the capital of the Bell General as reflected by their books.

"It is understood that you have the full rights of a stockholder in Solvex Refineries, Inc., and the Gilliland Pipeline Company with respect to those corporations' physical assets, good-will, and going concern value." (App. Vol. II, pg. 192)

On January 31, 1938, Freese received a 5% interest in all of Bell in exchange of all his interests in Bell Marketing Department, in the several refineries and pipelines, in subsidiaries of Bell, and, further all rights under prior contracts to Bell. (App. Vol. II, pg. 258-267). The 1938 contract provided that he receive the same salary of $800 per month, (App. Vol. II, pg. 259) a 5% interest in all Bell profits and a personal liability for 5% of all losses. (App. Vol. II, pg. 259). He *left all cash contributions* of $66,386.17 (investment account) *with Bell at no interest and subordinated to all creditors of Bell.* (App. Vol. I, pg. 259, 260, 274). Freese was to be a Vice President of Bell and did in fact have substantial management responsibilities. (App. Vol. I, 54, 98, 228) (App. Vol. II, pg. 272). Freese received monthly profit and loss statements and regularly questioned charges. (App. Vol. I, pg. 92) (App. Vol. II, pg. 285-289, 294-296). Freese was to receive 5% of all proceeds in excess of Bell's depreciated cost basis or bear 5% of the losses. On

liquidation of Bell, Freese first received his investment account then Bell received their cost basis. Thereafter they participated in profits and losses in their percentage ratio. (App. Vol. II, pg. 261-262). On termination of his contract, if Bell were not liquidated, then Freese was to receive his investment account balance plus 5% of the difference between the book value and the fair market value of assets acquired by Bell after February 1, 1938. (App. Vol. II, pg. 262-263). Thereafter, in 1941, except for increasing Freese's participation from 5% to 10%, and his salary from $800 to $1,000 substantially the same contract was renewed. (App. Vol. I., pg. 228, 229) (App. Vol. II, pg. 258-264, 272-278).

Under all the contracts, if Bell refused to pay funds or distribute his share of the assets within the time specified, then Bell was required to liquidate and pay Freese his pro rata part. (App. Vol. II, pg. 245-246, 261-262, 274-277). None of the agreements, 1926, 1929, 1934, 1938, nor 1941 were entitled Employment Agreements.

Freese was on a cash basis method of accounting and annually reported his percentage of the profits and losses on his tax return in the year the amounts were credited to his investment account and not in the year they could be distributed.

Under the 1941 contract Freese was entitled to withdraw his profits from Bell, as follows:

> " • • • at such times as distributions are made to a stockholder of Bell in the nature of dividends • • • on the basis of ten percent of the profits before income taxes represented by such distribution to stockholders • • • " (App. Vol. I, pg. 196, 224) (App. Vol. II, pg. 273, 274).

As of December 31, 1938, December 31, 1939, December 31, 1940, and December 31, 1941, Freese's investment account reflected a value in excess of 10% of the net worth of Bell. (Pl. Ex. 33, Sch. 2; 34, Sch. 2; 35, Sch. 3: 36, Sch. 2).

Plaintiff's investment account year end balances since 1935 were as follows:

| | | | |
|---|---|---|---|
| 1935 | 23,051.93 | 1950 | 125,403.34 |
| 1936 | 34,303.66 | 1951 | 115,464.84 |
| 1937 | 10,810.30 | 1952 | 110,451.25 |
| 1938 | 65,860.42 | 1953 | 100,566.08 |
| 1939 | 67,281.14 | 1954 | 82,291.94 |
| 1940 | 77,681.49 | 1955 | 75,342.48 |
| 1941 | 80,269.97 | 1956 | 63,207.16 |
| 1942 | 110,452.45 | 1957 | 45,363.87 |
| 1943 | 100,266.97 | 1958 | 41,457.53 |
| 1944 | 99,768.96 | 1959 | 30,698.13 |
| 1945 | 88,611.52 | 1960 | 31,817.89 |
| 1946 | 97,585.09 | 1961 | 21,888.39 |
| 1947 | 140,004.32 | 1962 | 14,390.33 |
| 1948 | 133,494.71 | 1963 | 4,039.33 |
| 1949 | 146,568.09 | 1964 | 1,575.18 |

(App. Vol. I, pg. 69) (Vol. II, pg. 1-24).

Under all contracts in the event operations by Bell resulted in a loss instead of a net profit, then Freese was personally charged with his percent of such loss. (App. Vol. II, pg. 273). When tax adjustments or auditing adjustments were made by the Internal Revenue Service or Bell's auditors, Freese's investment account was credited with his pro rata part of the adjustments even though the adjustments related to several prior years. (App. Vol. II, pg. 294-295).

The Government's own expert witness testified that a cash basis employee does not report as income money that he cannot withdraw from a corporation. (App. Vol. I, pg. 151-152). He further testified that under a joint venture relationship the same taxpayer would annually report the money as income. (App. Vol. I, pg. 152).

The Government's expert witness further testified to the exact facts in this case and stated that he treated the payments as proceeds from the sale of a capital asset. (App. Vol. I, pg. 126, 140, 143-145).

In 1965, the assets of Bell were sold to L & V Company. *At that time Bell requested Freese to personally indemnify and hold the buyer harmless to the extent of his 10% interest from any liabilities or claims not reflected on the December 31, 1964, Balance Sheet.* (App. Vol. II, pg. 282).

## F. REASONS FOR ALLOWANCE OF WRIT

This Court has previously reviewed the criterion for determining a husband and wife partnership in *Commissioner v. Culbertson*, 337 U.S. 733 (1949). It is well recognized that proof of a husband and wife partnership is the most strenuous test for defining partnership. Further, a joint venture definition is much broader than the definition of a legal partnership. (Reg. Sec. 301.7701-(a); Reg. Sec. 301.7701-3; Mertens Vol. 6, para. 35.02, pg. 11; Rev. Rul. 54-613, 1954-2 CB 269; Rev. Rul. 54-614, 1954-2 CB 271; H R Rept. # 708 72nd Cong. 1st Sess. 53 (1932); S. Rept. # 665, 72nd Cong., 1st Sess., 59 (1932). The partnership tests set out in *Culbertson*, Supra had also been outlined in *Commissioner v. Tower*, 327 U.S. 280, 286-7 (1946).

**The principal tests outlined by this Court for defining a partnership are:**

**1. Joint contribution of capital or services for the purpose of carrying on a trade or business.**

**2. Sharing in profits and losses.**

**3. An agreement and compliance thereunder.**

**4. Representations to third parties.**

**1.**

The tests above were all satisfied in the present case except item 4, the representations to third parties.

Though your Petitioners attempted to introduce the

testimony of witness Shakely, the Trial Court refused to allow him to testify regarding representations of a partnership relationship by the contracting parties. The Trial Court rejected the offered testimony of a disinterested third party as being "neither appropriate nor competent." In this decision the Trial Court refused to hear testimony this Court has ruled constituted a critical test in defining a partnership. The testimony was appropriate and competent. It was reversible error not to allow the testimony, particularly since it was the only testimony offered by either side relating to representations to unrelated third parties.

2.

Crucial to the Trial Court's decision is the finding that Freese held a debtor-creditor relationship with Bell, to-wit; he loaned Bell his investment and earnings each year.

Historically, indebtedness for tax purposes has been defined as an unconditional and legally enforceable obligation for the payment of money. *Autenreith v. Commissioner*, (3 Cir. 1940) 115 F. 2d 856, affg. 41 BTA 319.

> "The mere fact that the agreement itself recites that the money advanced was a loan does not make it so, if other provisions in the agreement clearly indicate otherwise." 6 J. Mertens, Federal Income Taxation, ¶ 35.03 (1968 Rev.) accord pg. 20; *Haley v. Commissioner*, 203 F. 2d 815 (5 Cir. 1953), rev'g 16 T.C. 1509 (1951); *Estate of L. O. Koen*, 14 T.C. 1406 (1950).

Under the Internal Revenue Code a debt arises from a bona fide debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money. *Bercaw v. Commissioner,* (CA 4 1948) 165 F. 2d 521; *Gillman v. Commissioner,* (CA 8 1931) 53 F. 2d 47; *Zimmerman v. U.S.,* (CA 9 1963); *Mervin R. Lippman,* 52 TC 135, 139. Where the obligation to pay was conditioned on the success of a lawsuit, the amount was held not to be a loan. See *Bercaw v. Commissioner,* 165 F. 2d 521, 525 (4 Cir. 1948), affg. T.C. Memo 47-005. See also *Milton Bradley Co. v. United States,* 146 F. 2d 153, 155 (1st Cir. 1944).

Where payment was due only after debts and costs of liquidation were satisfied, the 9th Circuit held the amount to be an investment. *Alexander and Baldwin Ltd. v. Kanne,* 190 F. 2d 153 (9 Cir. 1951)

In the instant case $66,386.17 was left with the Bell in 1938. In 1941 the amount was $80,269.97. In 1949 it was $146,568.09. At all times the monies left with Bell were subordinated to general creditors, bore no interest, was not evidenced by a note, was at risk with Bell. The amount of the alleged "debt" varied from month to month based upon the operations of Bell. Repayment of the "debt" was to be made in liquidation " • • • after adequate reserves are set up for taxes, losses, and other contingencies • • " (App. II, 204-225, 261 and 275) "or withdrawn when dividends were paid to stockholders"

and in direct proportion to his percentage of participation (App. Vol. II, pg. 273-274). On the books and records of Bell, cash put in by Freese and left with Bell was identified as "equity contributions," "equity," or "contribution of capital." (App. Vol. II, pg. 4, 184, 188, 191, 192, 251, 286, 289)

In 1938 and in 1941 the money Freese invested in Bell exceeded his participation percentage in the net worth of Bell. (App. Vol. I, pg. 40, 41, 42, 69) (App. Vol. II, pg. 1-24; Sch. 2 of Pl. Ex. 33, 34, 35, and 36).

Bona fide debt under Sec. 166 of the Internal Revenue Code is defined as:

> " . . . a bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. . . . " (Reg. Sec. 1.166-1)

The prior law regarding bona fide indebtedness was codified in 1969 under Sec. 385 of the Internal Revenue Code, wherein the factors for determining indebtedness were identified as follows:

> "(b) FACTORS. The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:
>
> (1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum

certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) Whether there is subordination to or preference over any indebtedness of the corporation,

(3) The ratio of debt to equity of the corporation,

(4) Whether there is convertibility into the stock of the corporation, and

(5) The relationship between holdings of stock in the corporation and holdings of the interest in question." (Sec. 385)

It is the Petitioners position that as a matter of law the money left with Bell at no interest, not evidenced by a note, subordinated to all creditors, subject to the fluctuations of Bell profits and losses, distributable to Freese when dividends were paid to stockholders and in direct proportion to his percentage of participation, was not and could not be a loan. It was not an unconditional obligation to repay but was conditioned upon the profitability of Bell.

## III.

Petitioners respectfully submit that the Trial Court did not apply the court tests for defining a joint venture nor in fact were the partnership tests as set out by this Court and lower courts for family partnerships applied.

In *Culbertson* Supra this Court set forth a most detailed study of family partnership criterion. Sec. 7701 and the regulations thereunder (Reg. Sec. 301. 7701-1(c) and

3(a) merely enlarged the general definition of partnerships to cover a multitude of business relationships. The case law has delineated the tests.

There is no question that both Bell and Freese contributed capital and services to the joint venture. Equally clear is the proof that Freese's capital contribution exceeded his percentage of the net worth of the business. Nor is it in dispute that historically Freese owned an interest in the assets of Bell.

1929:

"that the sum of $25,000 is to be promptly deposited with the Altitude Petroleum Corporation * * * and that henceforth this account shall be designated as DEPOSIT FUND instead of RESERVE FUND, which shall remain to answer all the conditions and purposes for which said RESERVE FUND is mentioned in the aforementioned contract, that same shall henceforth be construed to mean DEPOSIT FUND." (App. Vol. II, pg. 231)

1931:

"I want to state that all physical assets such as the former Peerless Refinery at Chanute, should we purchase same, the Operators Oil Company's Oklahoma City pipeline, and whatever else we purchase for Altitude; will be the property of the Altitude; but of course, both of you will own your share of the physical assets, not only the profits and losses." (App. Vol. II, pg. 174-175)

1934:

"Interest on capital invested in Marketing Department." (App. Vol. II, pg. 251)

1934:

"In the preparation of our annual statement Ben and I both believe that we are justified in considering your commission account as a capital contribution and so avoid the necessity of showing same as a contingent or actual liability. * * *" (App. Vol. II, pg. 184)

1936:

"Herewith is check for $5,000 on account of payment due per agreement for equity in certain Texas interests." (App. Vol. II, pg. 179)

1936:

"Resolved, that Albert Finston and Benedict I. Lubell be and they hereby are authorized to enter into negotiations with and execute agreements with I. A. Anson and M. Lloyd Freese covering the interest of those individuals in the stock of the Solvex Refineries, Inc., and Gilliland Pipeline Company." (App. Vol. II, pg. 299)

1936:

"This letter will confirm our understanding that the ownership by this company (Bell) of all the capital stock of Solvex Refineries, Inc., a Texas corporation, and one-half of the capital stock of the Gilliland Pipeline Company, a Texas corporation, is for the Marketing Department of this company in which you have a one-half interest.

* * *

"It is understood that you have the full rights of a stockholder in Solvex Refineries, Inc., and Gilliland

Pipeline Company with respect to those corporations' physical assets, goodwill, and going concern value." (App. Vol. II, pg. 181-182)

1937:

"It is understood that you have the full rights of of a stockholder (even though not legal ownership of stock) in Solvex Refineries, Inc., and the Gilliland Pipeline Company with respect to those corporations' physical assets, goodwill, and going concern value.

* * *

"The other memorandum which would be needed to complete this, to-wit, one from the Bell General to evidence the credit on its books we cannot, of course, give you but it is understood that you will have your share of the undistributed profits of this corporation, as well as your respective interest in the capital of the Bell General as reflected by their books." (App. Vol. II, pg. 192-193)

1937:

"Liquid Transit Corporation has loaned Bell Oil & Gas Co. $8,500 as of 2/15/37. You are entitled to interest on your proportionate part of this money and adjustment therefore will be made at a later date." (App. Vol. II, pg. 253)

1937:

"Whereas, the Bell Oil & Gas Co., I. A. Anson, and M. Lloyd Freese comprise the Bell Oil & Gas Co. Marketing Department, and Whereas, by contracts previously executed, it is agreed that the Solvex Refineries, Inc., is a venture of Bell Oil & Gas Co. Marketing Department, and

• • •

"Whereas, the interest of M. Lloyd Freese is one-fourth of the total Bell Oil & Gas Co., interest in the original Marketing Department existent before the organization of the Solvex Refineries, Inc.

• • •

"That the profits or losses of Solvex Refineries Inc., be credited or charged to Anson and Freese accounts, respectively monthly, as their interests in said profits or losses appear." (App. Vol. II, pg. 254-257)

1937:

"Attached find statement which shows the equities of Bell Oil & Gas Co., and Anson and Freese respectively in the Bell Marketing Department and Solvex for the month of March." (App. Vol. II, pg. 185)

1937:

"Attached find analysis of your interest in The Bell Oil & Gas Company (and subsidiáries) which is self explanatory." (App. Vol. II, pg. 285)

1937:

"• • • you shall in effect have the rights of stockholders, but the entries on the books necessary to carry out the intent of this provision were never made since the Bell reflected its total investment in these companies as an asset on its own and then reflected a liability to you in the form of a credit balance." (App. Vol. II, pg. 192)

1937:

"We understand that when the Bell Oil & Gas Co., issues its annual financial statement, that such credits as may be due us, are not reflected as liabilities of the Company, but are included, and properly so, as working capital of the Company." (App. Vol. II, pg. 293)

1937:

"Attached find statement which shows the equities of Bell Oil & Gas Co., and Anson and Freese respectively in the Bell Marketing Department and Solvex for the month of March." (App. Vol. II, pg. 195)

1938:

"M. Lloyd Freese Equities in Bell Oil & Gas Co., and associated companies, as of January 31, 1938.

* * *

"Total Equities in all Companies as at 1/31/38, $66,386.17." (App. Vol. II, pg. 269)

1938:

"I hand you herewith a detailed statement of your account as at 1/31/38, which shows your equity as of that date to be $66,386.17. * * *" (App. Vol. II, pg. 268)

1961:

"You will ultimately receive your 10% of this enhanced value of Ben Franklin through Ben Franklin's dividends to Bell or revaluation of Ben Franklin upon termination of the contract, as provided in

item 5 and 7(d) of your contract." (App. Vol. II, pg. 297)

1965:

"I. We have advised you that as a part of the consideration in the impending sale of assets by Bell Oil & Gas Company to L & V Company. Bell will guarantee its financial statement of December 31, 1964, as prepared by Peat, Marwick, & Mitchell, Certified Public Accounts, and will agree to indemnify and hold the buyer harmless from any liabilities or claims not therein shown. As a part of our negotiations with you, we have earlier asked that you personally assume an undivided 10% of such liability. This will confirm the fact that our request to you to participate in such guarantee has been withdrawn and does not constitute a part of our compromise and settlement with you nor shall you have any liability for the representations, guarantees or warranties made by Bell to L & V Company."

In applying this court's tests of partnership, the lower courts have often varied the emphasis of certain criterion, but never have the lower courts totally disregarded these tests. The instant case brings forth the need for requiring more emphasis on these tests.

In passing it should be noted that two companion cases out of the 10th Circuit were totally disregarded. (See *Kasishke v. Baker*, 146 F. 2d 113 (10 Cir. 1944) and *Baker v. U.S.*, 233 F. 2d 195 (10 Cir. 1956)

Where there has been a total disregard for the law and the tests set out by this Court for interpreting the law, a review is required.

## CONCLUSION

A review by this Court is proper because

1. The lower court rejected as incompetent testimony which this court has ruled is relevent to show intent.

2. The lower court found a debtor-creditor relationship existed in direct conflict with the criterion for finding the existence of a debt under the prevailing law and the statutes.

3. This court has not previously ruled upon the definition of a joint venture for tax purposes. For the orderly application of the tax laws clarification is needed.

4. The lower court has so far deviated from the rule of law defining partnerships that this court should exercise its broad powers of supervision.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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## APPENDIX A

[¶72-429]

M. Lloyd FREESE and Dorothy M. Freese, PLAINTIFFS-APPELLANTS v. U.S., DEFENDANT-APPELLEE. U.S. Court of Appeals, Tenth Circuit, No. 71-1193, Feb. 23, 1972. District Court, 27 AFTR 2d 71-578, affirmed. Year 1965. Decision for Govt.

1. CAPITAL GAINS AND LOSSES — contracts and leases — employment contracts. Capital gains treatment denied employee of corp. for amounts received from sale of corporate assets. Employment didn't make employee owner of any interest in corp. Lump sum in satisfaction of what is in reality compensation under employment contract is ordinary income. *References:* 1972 P-H Fed. ¶ 7034(60); 32,642.

2. JUDICIAL PROCEEDINGS — Suits against U.S. — refund suits — prerequisites. Taxpayer could not raise issue of applicability of income averaging on appeal. Taxpayer never raised issue in lower court nor made issue part of refund claim. *Reference:* 1972 P-H Fed. ¶ 38,804(20).

E. John Eagleton and John M. Freese for Plaintiffs-Appellants.

Issie L. Jenkins, Meyer Rothwacks, Paul M. Ginsburg, Jane M. Edmisten, Attys., Johnnie M. Walters, Asst. Atty. Gen., Tax Div., Dept. of Justice, Wash., D. C.,

Nathan G. Graham, U.S. Atty., Robert P. Santee, Asst. U.S. Atty., Tulsa, Oklahoma, Ben Douglas, William W. Guild, Attys., Tax Div., Dept. of Justice, Fort Worth, Texas, for Defendant-Appellee.

Appeal from the United States District Court for the Northern District of Oklahoma.

Before LEWIS, Chief Judge, and HOLLOWAY and DOYLE, Circuit Judges.

DOYLE, Circuit Judge:

This cause is a tax refund suit in which Dorothy M. Freese, as executrix of the estate of M. Lloyd Freese, deceased, seeks to recover income taxes and interest in the total amount of $234,190.27. The action revolves around a lump sum payment totaling $555,000 received by M. Lloyd Freese in 1965, pursuant to a contract of compromise and settlement. The demand of plaintiff represents the difference between ordinary income on which the tax was paid and the amount of tax payable under capital gain treatment. Freese maintains that the sum distributed was not ordinary income, and it is this issue which we must determine.

The district court held that M. Lloyd Freese had been an employee of Bell Oil & Gas Company throughout the period; that this payment represented accumulated commissions; and that since the relationship was one of employer-employee all of the amount paid was

compensation for services rendered and, therefore, was taxable as ordinary income.

Although the final contract, as amended, between the parties which was executed in 1941 seems definitive as to the property interest which Freese had in the Bell Oil & Gas Company prior to its sale in 1965 (to L & V Company for a sum in excess of $10,000,000), it is necessary to at least summarize the background facts in order to review the question as to whether the mentioned distribution was a capital asset subject to the capital gains provisions of the Internal Revenue Code.

The Bell Company was organized in 1918 by Samuel L. Lubell, a New York manufacturer and investor, and Samuel Lamport, for the purpose of engaging in the production and sale of oil and gas. Lubell and Lamport invested $500,000 each in this company and owned all of the shares of stock with the exception of a few qualifying shares. Subsequently, Lubell acquired all of the stock, and during the periods here in question Lubell and members of his family, together with a charitable foundation, owned the Bell stock.

During the early period of the Bell Company, Freese and one I. A. Anson were also engaged in the oil and gas business in Oklahoma. They had organized the Altitude Petroleum Corporation which had competed with Bell, but which later merged with and became in substance the marketing division of Bell. A new Altitude Cor-

poration was formed and the stock was issued to Bell. From the very beginning Freese and Anson were regarded and treated as employees. For example, a 1928 agreement provided in part:

> It is contemplated that a Corporation be organized by First Party (Bell) * * * and that second parties (Anson and taxpayer) shall be placed in charge of the said business upon profit sharing plan * * * (Appendix, p. 220).

Freese and Anson were at all times subject to the control of Bell even though they were employed to deal on behalf of Altitude. They received $700.00 per month plus 25 percent of the net profits derived from the business, but they were not allowed to make advance drawings on either salary or profits. Bell controlled the extension of credit by Altitude and also the collections by Altitude.

The 1934 employment contract provided for a reserve fund to protect Bell against losses suffered by Altitude under the management of Freese and Anson. In subsequent contracts the amount of the initial required deposit was increased somewhat and profits were credited to this account. To a limited extent Freese was allowed to draw down some of these profits, and he reported and paid income taxes annually on the amount which had been credited to his account. In 1934 Bell entered into a new contract with Freese and Anson which provided in part:

Second parties were heretofore employed by Altitude Petroleum Corporation, engaged in the marketing of petroleum products. It is the intention of those interested in the Altitutde Petroleum Corporation to liquidate its business, pay all of its liabilities, declare liquidating dividends from time to time, and dissolve such corporation.

It is further contemplated that Altitude Petroleum Corporation shall cease doing business and any unfinished profitable contracts belonging to it will be transferred and assigned to first party. Thereafter first party will employ each of the persons composing second parties for the purpose of managing its Marketing Department upon terms and considerations presently to be stated.

It continued:

1. *Object of Employment.* First party does by these presents employ severally each of the persons composing second parties and the latter hereby accept the said employment for the term and for the considerations hereinafter stated.

Money furnished by Freese and Anson to the Marketing Department of Bell thenceforth earned six percent interest. They were treated as managing agents, but the contract specifically provided for them to be subject to the control of Bell. They were given a 25 percent share of the profits of the Marketing Department or Division of Bell. At the same time, they were made individually and severally liable for 25 percent of losses incurred, and the mentioned reserve fund in the initial amount of $50,000 was continued. A contract provided for the

make up of this reserve fund, but the specifics of this are not relevant to the present inquiry. Following the establishing of the $55,000 fund, Freese was to be paid profits realized on a monthly basis, and also interest at the rate of six percent was credited to the reserve account.

Although both Anson and Freese were made vice-presidents of Bell, Section 21 of the contract read:

> The relation of the parties hereto is principal as to first party and agent severally as to each of the persons composing second parties; and notwithstanding the provisions herein for sharing of profit and losses, nothing herein contained shall be construed as a relation of partnership or joint adventure between the parties, and second parties shall not have the right to bind first party as a partner or co-adventurer, either as between the immediate parties, or as to third persons; and all of the rights, duties and obligations of the parties hereto shall be measured and controlled by the principles applicable to the relation of principal and agent.

The length of this contract was 10 years. However, there was a right to terminate on 90 days' notice in the event gross profits fell below the level achieved on a monthly average from June 1, 1933 to June 1, 1934 during any consecutive six-month period after February 1, 1935.

Still another agreement was entered in 1938 changing the share of profits from 25 percent of the Marketing

Department to five percent of the total net profits of Bell including "income from investments, dividends and sale of assets, as well as the income from the normal business operations conducted by first party" (Bell). This 1938 agreement also contained an assignment by Freese and Anson to Bell of all right and title to property that they might have acquired in prior agreements when they were in the Marketing Department of Bell.

The final agreement and the one with which we are concerned was entered into on July 1, 1941. Bell again "employed" Freese as a vice-president. His remuneration was increased to $1,000 per month and ten percent of all profits earned by Bell, again including income from investments, dividends and sales of assets as well as income from the normal business operations conducted by Bell. He was again made liable for ten percent of any net loss.

The indebtedness owed Freese by Bell "as represented by Freese's credit balance on the books of Bell" was again subordinated to "the rights of any and all other creditors of Bell except only any indebtedness due and owing from Bell to I. A. Anson, and except any other indebtedness due and owing from Bell to any other of its employees or officers for services rendered * * *." As he had been theretofore, Freese was given the right to require arbitration of the value of assets in the event of dissolution or liquidation of Bell,

to the end of properly determining the amount due to him under the provisions previously outlined.

We gather from a study of the record in this case that assets of various kinds were sold and profits were realized and credits were given during the years subsequent to 1941 until 1965. As previously noted, Freese paid his taxes on these items each year and he treated them as ordinary income. We are not here concerned with any of these transactions.

It was in 1965 that the assets of Bell were sold to L & V Company for a total in excess of $10,000,000. Freese did not take any part in the negotiations leading to this sale, but he was asked to be liable for ten percent of any liabilities which arose pursuant to the sale. This request was later abandoned.

On June 25, 1965, Freese and Bell entered into the compromise settlement which provided for the $555,000 payment. This agreement recited that it was the product of a good faith controversy between Freese and Bell as to the amount that would be due him under the previous agreement upon consummation of the sale of Bell to L & V. Freese accepted the $555,000 as full and complete payment, satisfaction, compromise and settlement of every sum due under the agreement.

The basic relationship of employer-employee threads through all of the contracts and pervades most of the

acts and doings of the parties. Each and every contract emphasized that Freese was an employee and not an owner because he owned no stock in the company at any time; his closest approach to owning an asset arose from his ten percent interest in the profits realized from the sale of corporate assets. Thus, he had the right to the increment in the value of the assets from the time of his contracts and by reason of this fact he claims that the property awarded to him was a capital asset (pursuant to 26 U.S.C. § 1221) subject to the rate applicable to long-term capital gain. An alternative contention is that if this sum is determined to be ordinary income, he at least is entitled to utilize the averaging provisions of § 1301 of the 1954 Internal Revenue Code in accordance with pre-1964 Treasury Regulations § 1.1301a-1. This latter issue was not raised before the trial court and is before us for the first time on this appeal.

The district court found that the only relationship between plaintiff and Bell was that of employee-employer.[1]

[1] The court found:
"• • • Plaintiff was never a stockholder of Bell. He did not attend and was not invited to attend stockholders' meetings of Bell. Plaintiff was never a member of the board of directors of Bell. Plaintiff was never a signatory on the checking accounts of Bell, and did not sign checks of Bell. Under the employment contracts, plaintiff was chargeable with a percentage of losses, if any; however, his liability in this respect was limited to the balance in his

(continued on page 34)

The court concluded that the sum involved did not qualify as a capital asset despite the fact that it was paid in a lump sum; that it was compensation for services rendered and was thus ordinary income.

We agree with the findings and conclusions of the district court and affirm its judgment.

I

[1] A threshold principle is that in order for a transaction to be ruled a capital gain, it must bring itself within either 26 U.S.C. § 741 (partnership interest) of 26 U.S.C. §§ 1221 and 1222 (the basic capital gains provisions) and as such must involve a "capital asset" which is defined in § 1221 to be property held by the taxpayer. In analyzing and correlating the evidence and

(continued from page 33)
account on the books of Bell. Even if the plaintiff's liability for his percentage of the losses were not so limited, this factor in and of itself would not make the plaintiff an owner of an interest in Bell or its assets."

The court continued:

"10. Under the 1941 employment contract, plaintiff had the right to arbitrate the value of the assets of Bell in determining his 10 percent profits from the sale of such assets upon the liquidation of Bell. On June 25, 1965, after Benedict Lubell had negotiated the sale price of the assets of Bell, plaintiff and Bell entered into a Compromise Agreement whereby plaintiff accepted $555,000 as full and complete payment of his profits in Bell. Approximately $20,000 of this payment represented the balance of plaintiff's profits in the operations of Bell and the remainder represented his 10 percent of the profits realized by Bell from its sale of the assets."

law we are mindful that the Supreme Court has held that the term "capital asset" is a narrow category and under the congressional scheme an exception rather than the rule for the treatment of income.[2]

In light of the above, the taxpayer's contention that the relationship was that of copartnership or joint venture makes slight impact. For such a relationship to exist there must have been an intent among the parties involved to form it; the unambiguous terms of the agreement evidence no such intent. Furthermore, there is not the slightest suggestion that the 1941 agreement or any of its predecessors was a sham which sought to conceal or obscure the actual relationship of the parties. All of these contracts emphasize that Bell was an employer and at least one of these disavowed expressly that there was a partnership. Apart from this, the total circumstances fail to reveal that the actual relationship had any joint venture quality about it such as was contemplated by the Supreme Court in Commissioner of Internal Revenue v. Culbertson, 337 U.S. 733, 742 [37 AFTR 1391], 69 S. Ct. 1210, 1214, 93 L. Ed. 1659 (1949), wherein the Court said:

[2]Corn Products Refining Co. v. C.I.R., 350 U.S. 46, 52 [47 AFTR 1789], 76 S. Ct. 20, 24, 100 L. Ed. 29 (1955). See also Hort v. C.I.R., 313 U.S. 28 [25 AFTR 1207], 61 S. Ct. 757, 85 L. Ed. 1168 (1941); C.I.R. v. P.G. Lake, Inc., 356 U.S. 260 [1 AFTR 2d 1394], 78 S. Ct. 691, 2 L. Ed. 2d 743 (1958); C.I.R. v. Gillette Motor Transport, Inc., 364 U.S. 130 [5 AFTR 2d 1770], 80 S. Ct. 1497, 4 L. Ed. 2d 1617 (1960).

> The question is * * * whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

It is unnecessary then to analyze the relationship in detail since it is clear that there is neither a copartnership nor joint venture under any of the standards set forth in Culbertson, the expressions in which are still applicable to instances of non-family relationships.

II

We have not been content to be governed by the express terms of the contract describing the relationship as employer-employee in deciding whether the distribution qualified as a capital asset. We have proceeded to examine the history and nature of the property itself in an effort to determine its intrinsic nature and character. Regardless of how the matter is considered, we find that its inherent quality is that of deferred commissions and profits. In short, it was an employee profit sharing program. Freese was not granted a ten percent interest in the Bell Corporation. Instead, he received a ten percent interest in the increased value of assets. True, he was

extended the right to insist upon careful evaluation and arbitration of that evaluation and arbitration of that evaluation following disagreement, but even then the ultimate arbitration was final.

Nor do we agree that Freese's "bundle of rights" gave to this property the quality of a capital asset. The fact that the fund finally had considerable magnitude accumulated over a long period of time, while significant, is not determinative. Nor does the fact that the taxpayer had rights in connection with the computation of the profits attributable to the sale of assets change its quality. Nor can we give weight to the fact that he was a vice-president[2a] or acting in a managing capacity. None of these incidents changes the fact that this distribution was made up of commissions and earnings. It remained compensation, even though attributable to the sale of corporate assets of various kinds. The fact of deferment and accumulation cannot change this basic nature or quality.

In Commissioner v. Ferrer, 304 F. 2d 125 [9 AFTR 2d 1651] (2d Cir. 1962), a similar contention was advanced. The court found two aspects of an entertainment contract to have the quality of capital assets. Ferrer had a lease on a play which he was to perform, created by an advance of $1,500. Incident thereto, he had a

[2a] After all, in this day and age the corporations appoint vice-presidents for various reasons and purposes.

negative power to prevent the sale of motion picture, radio and television rights until after production of the play. The court held that this latter was a capital asset subject to capital gain treatment on the occasion of his surrender of these rights. The control by Ferrer, however, of the asset was clear. The court pointed out that it was like a lease of land for a term. Freese did not have this kind of ownership. The fact that Ferrer had control over the asset does not furnish a favorable guide to Freese in the case at bar because the latter had no control in the sense that he could dtermine the time and circumstances of a sale.

This court's decisions have, in accordance with decisions of the Supreme Court, given a narrow construction to the term "capital asset." Wiseman v. Halliburton Oil Well Cementing Co., 301 F. 2d 654 [9 AFTR 2d 1389] (10th Cir. 1962) was a lump sum payment case. It was made in exchange for surrender of the right to grant sub-licenses and realize future earnings. This right was held to be nothing more than ordinary income. There the court said:

> • • • It contends here, however, that the right to control the issuance of sublicenses was a property right, and that when it relinquished that right to Stanolind and accepted a percentage of the royalties which Stanolind received from third party licensees, the income resulted from a sale or transfer of a capital asset. No method is suggested by which a

basis for the right transferred could be computed. The record indicates that substantially all costs of development were treated as expense rather than as capital investment made with the expectation of earning income in the future. The amount which Haliburton was willing to accept as royalty necessarily was based on which it could earn in the future under the exclusive arrangement. We think the royalty received by Halliburton under the 1953 agreement was no more than a substitute for future income which Halliburton would have received from granting third party licenses, had it chosen to exercise that right, and was not a return of capital. Commissioner of Internal Revenue v. P. G. Lake, Inc., 356 U.S. 260 [1 AFTR 2d 1394], 78 S. Ct. 691, 2 L. Ed. 2d 743; Hort v. Commissioner, 313 U.S. 28 [25 AFTR 1207] 61 S. Ct. 757, 85 L. Ed. 1168; Dyer v. Commissioner, 10 Cir., 294 F. 2d 123 [8 AFTR 2d 5487]; Commissioner of Internal Revenue v. Phillips, 4 Cir., 275 F. 2d 33 [5 AFTR 2d 855]. 301 F. 2d at 658.

Halliburton has precedential value here in that the interest involved there came much closer to qualifying as a capital asset than does the property with which we are here concerned; the income was nevertheless held to be ordinary. And, although Halliburton is not irreconcilable with Ferrer, the opinions and results in the two cases are somewhat at variance. Our holding here is agreeable to both cases.

Elliot v. United States, 431 F. 2d 1149 [26 AFTR 2d 70-5473] (10th Cir. 1970) is similar in effect to Halliburton. In Elliott the taxpayer received the sum of

$49,000 from his insurance company upon the termination of his contract. These monies were characterized as reimbursement for loss of future earnings and as such taxable as ordinary income. The sole right surrendered by the taxpayer was his contract right to continue as General Agent for the company.

In the case at bar we do not have the element of surrender of rights to future earnings or income. Freese was paid a lump sum composed of his ten percent commission on the sale of assets in accordance with his contract of employment. The settlement carries no significant legal consequence here, since it was simply an agreement arising from a dispute as to the amount which was due him. The only "right" which Freese gave up for present purposes in this connection was his contract right to an arbitration.

As we previously noted, the payments which were made or credited to Freese through the years had been treated as ordinary income by both Freese and the company. Although this is not dispositive of the question, it evidences the viewpoint of the parties through the years. We are of the opinion that the district court was correct in holding that this was income which did not differ in character from the payments and credits of prior years.

[2] The final question is whether the Freese estate should now be allowed to take advantage of the income averaging provisions of the Internal Revenue Code and

the regulations. The impediment to consideration of this question is that it is raised for the first time on appeal. A necessary prerequisite to maintaining an action for refund is the filing of a claim. See § 7422 of the Internal Revenue Code. The purpose of requiring that there is a fair presentation of the claim to the Internal Revenue Service is so as to avoid surprises. Flora v. U.S., 357 U.S. 63 [1 AFTR 2d 1925] 2 L. Ed. 2d 1165, 78 S. Ct. 1079 (1958); U.S. v. Felt & Tarrant Mfg. Co., 283 U.S. 269 [9 AFTR 2d 1416] 75 L. Ed. 1025, 51 S. Ct. 376 (1931); Herrington v. U.S., 416 F. 2d 1029 [24 AFTR 2d 69-5694] (10th Cir. 1969); see 10 Mertens, Law of Federal Income Taxation, 1966 Revision § 58A.06.

To take up this matter now would be to make factual determinations which were not presented to the district court. This we cannot do.[3]

The taxpayer's contention that he was not able to press the income-averaging issue until he had exhausted all possibilities of establishing his right to capital gain treatment is something less than a compelling basis. Therefore, we must deny the present request that the cause be remanded for determination of the applicability of § 1.1301a-1 of the regulations.

The judgment of the district court is affirmed.

[3]The income-averaging provisions require, before a taxpayer may come thereunder, that he show that he (1) was engaged in employment; (2) for a period of over 36 months, and (3) received 80 percent of his total compensation for such employment in the lump sum questioned. Pre-1964 averaging provisions, T.R. 1.1301a-1. Clearly number (3), at least, would involve the making of factual determinations which could become, in this case, quite complex.

## APPENDIX B

[¶71-391]

M. Lloyd FREESE and Dorothy M. Freese, PLAINTIFFS v. U. S., DEFENDANT, U. S. District Court, N. Dist. of Okla., No. 68-C-247, Jan. 13, 1971. Year 1965. Decision for Govt.

1. CAPITAL GAINS AND LOSSES — Contracts and Leases — Employment contracts. Capital gains treatment denied employee of corp. for amounts received from sale of corporate assets. Employment didn't make employer owner of any interest in the corp. Lump sum in satisfaction of what is in reality compensation under employment contract is ordinary income. *Reference:* 1971 P-H Fed. ¶ 32,642.

E. John Eagleton, 204 Philtower Bldg., John M. Freese, 604 Nat. Bk. of Tulsa Bldg., Tulsa, Okla., Attys. for Plaintiffs.

Robert P. Santee, Asst. U. S. Atty., 460 U. S. Courthouse, Tulsa, Okla., Ben Douglas, William W. Guild, Tax Div., Dept. of Justice, 7A06 Federal Bldg., 819 Taylor St., Ft. Worth, Tex., Attys. for Defendant.

### Findings Of Fact and Conclusions Of Law

BARROW, District Judge:

This matter was tried before the Court without a

jury on December 7, 8, and 9, 1970, at Tulsa, Oklahoma. After considering the pleadings, stipulations of the parties, testimony, documents, and arguments of counsel, the Court makes and enters its findings of fact and conclusions of law as follows:

Findings of Fact

1. This is a refund suit brought by Dorothy M. Freese, individually and as Executrix of the Estate of M. Lloyd Freese, deceased, plaintiff,* against the United States of America, defendant, for the recovery of income taxes and interest in the amount of $234,190.27, plus statutory interest.

2. The questions presented for determination are as follows:

(a) Whether a payment in the amount of $555,000 to the plaintiff in 1965 under an employment contract is taxable as ordinary income or as gain from the sale of a capital asset; and

(b) Whether the plaintiff is entitled to certain deductions for alleged business expenses in the aggregate amount of $3,472.08 in 1965.

3. In 1918, Samuel L. Lubell, deceased, a New York

*M. Lloyd Freese, deceased, is referred to herein as "plaintiff." M. Lloyd Freese instituted this action and was joined by his wife, Dorothy M. Freese, because a joint income tax return was filed for the year in suit. Dorothy M. Freese, as Executrix of the Estate of M. Lloyd Freese, deceased, was substituted as a party plaintiff upon the death of Mr. Lloyd Freese.

manufacturer and investor, and another New York industrialist, Samuel Lamport, helped organize Bell Oil & Gas Company, referred to herein as Bell or Bell Company, for the purpose of engaging in the production and sale of oil and gas. Lubell and Lamport, jointly, invested $500,000 in the capital of Bell. Bell had a total capital of $1,000,000. By the early part of 1927, Lubell owned all of the shares of stock of Bell except for three qualifying shares. From that time until the liquidation of Bell in 1965, Lubell and members of his family and the family charitable foundation owned all of the stock of Bell.

4. In 1934, Bell employed M. Lloyd Freese, deceased, plaintiff, and one I. A. Anson, as executives of Bell. Plaintiff and Anson had been jointly involved with Bell in the operations of another corporation, Altitude Petroleum Corporation prior to that time. The employment contract, dated July 28, 1934, provided that plaintiff and Anson were to manage Bell's marketing division in consideration of a fixed salary of $800 per month, plus 25 percent of the net profits (or losses) of Bell's marketing and traffic departments. The contract provided in, part:

> • • • all of the duties hereby assumed by second parties [Anson and plaintiff] and the means and manner of accomplishing the same shall at all times be subject to the control of first party [Bell].

In addition, the contract provided:

> Relation Of Parties. The relation of the parties hereto is principal as to first party [Bell] and agent

severally as to each of the persons composing second parties [Anson and plaintiff]; and notwithstanding the provisions herein for sharing of profit and losses, nothing herein contained shall be construed as a relation of partnership or joint adventure between the parties, and second parties [Anson and plaintiff] shall not have the right to bind first party [Bell] as a partner or co-adventurer, either as between the immediate parties, or as to third persons; and all of the rights, duties and obligations of the parties hereto shall be measured and controlled by the principles applicable to the relation of principal and agent.

As part of the employment contract, plaintiff and Anson agreed to deposit with Bell $15,000 each to be kept on the books of Bell as a "reserve fund" in order to save Bell harmless on losses, if any, to be borne by plaintiff and Anson under the contract. Plaintiff and Anson were given 6 percent interest on the balances maintained in their respective accounts.

5. During the 1930's, Bell organized and purchased interests in various operations, including Solvex Refineries, Inc., and Bell General Pipe Line Company (successor in interest to Gilliland Pipe Line Company). Plaintiff and Anson also owned interests in Solvex and Bell General.

6. On February 1, 1938, plaintiff and Anson entered into separate employment contracts with Bell. Bell agreed to employ plaintiff as vice-president and plaintiff "accepted such employment" for a salary of $800 per month,

plus 5 percent of the net profits (or losses). The net profits included any appreciation (or loss) realized by Bell from the sale of its assets. Under the employment contract, plaintiff agreed to allow his credit balance on the books of Bell to remain with the company as an "indebtedness" without interest. The amount credited to plaintiff under this contract was $66,386.70. This included the value of plaintiff's interest in Solvex and Bell General Pipe Line Company which were assigned to Bell.

Simultaneously with the execution of the 1938 employment contract, plaintiff and Anson entered into an agreement with Bell, in consideration of the new employment contracts, assigning all their interests in Solvex and Bell General to Bell. In addition, plaintiff and Anson surrendered and disclaimed any possible rights or interests they might have or claim in Bell or its assets.

7. On July 1, 1941, Bell and plaintiff entered into a new employment contract. Like its predecessors, this contract refers to the plaintiff as an employee and the continuing credit balance in plaintiff's account as an indebtedness owned by Bell. The 1941 contract, with modifications not material to this determination, remained in effect on a year-to-year basis until plaintiff's employment was terminated in 1965. Under the 1941 employment contract, plaintiff's compensation was increased to a fixed salary of $1,000 per month, plus 10 percent of the profits (or losses) of Bell. The net profits included

any appreciation (or loss) realized by Bell from the sale of its assets. Plaintiff's credit on the books of Bell was subordinated to the rights of other creditors of Bell; however, his indebtedness was not subordinated to but rather had preferred treatment over the capital of the Lubell family in Bell.

8. Benedict Lubell, son of Samuel Lubell, deceased, became the chief executive officer of Bell in 1938. Later, upon the death of his father, Benedict Lubell succeeded as representative of the stockholders of Bell, that is, the Lubell family and the family foundation. In 1965, Benedict Lubell sold the assets of the company without any participation by the plaintiff.

9. The only relationship between plaintiff and Bell was that of employee and employer. Plaintiff was never a stockholder of Bell. He did not attend and was not invited to attend stockholders' meetings of Bell. Plaintiff was never a member of the board of directors of Bell. Plaintiff was never a signatory on the checking accounts of Bell, and did not sign checks of Bell. Under the employment contracts, plaintiff was chargeable with a percentage of losses, if any; however, his liability in this respect was limited to the balance in his account on the books of Bell. Even if the plaintiff's liability for his percentage of the losses were not so limited, this factor in and of itself would not make the plaintiff an owner of an interest in Bell or its assets.

10. Under the 1941 employment contract, plaintiff had the right to arbitrate the value of the assets of Bell in determining his 10 percent profits from the sale of such assets upon the liquidation of Bell. On June 25, 1965, after Benedict Lubell had negotiated the sale price of the assets of Bell, plaintiff and Bell entered into a Compromise Agreement whereby plaintiff accepted $555,000 as full and complete payment of his profits in Bell. Approximately $20,000 of this payment represented the balance of plaintiff's profits in the operations of Bell and the remainder represented his 10 percent of the profits realized by Bell from its sale of the assets.

11. On June 30, 1965, plaintiff left Bell. During the remainder of 1965, plaintiff held himself out as a consultant in the oil and gas industry. In this connection, plaintiff incurred the following expenses:

| | |
|---|---|
| Travel | $ 544.89 |
| Gifts | 328.33 |
| Entertainment | 1,370.23 |
| Automobile | 1,228.63 |
| Total | $3,472.08 |

12. Plaintiff filed an income tax return for the year 1965 in which he reported the $555,000 payment as income from his "sale of assets." Plaintiff reported his cost basis in these assets as $17,900. The $17,900 represented attorney's fees and accountant's fees incurred by the plaintiff in 1965 in connection with his negotiation

of the settlement with Bell. Thus, plaintiff in his income tax return reported no original cost basis (investment) in the assets.

13. Upon audit of the plaintiff's income tax return for 1965, the Commissioner determined that the $555,000 payment was compensation for services rendered to Bell and taxable as ordinary income. The Commissioner also disallowed the deductions claimed by plaintiff as business expenses in the amount of $3,472.08.

14. The Court finds that the plaintiff did not own any interest in Bell or in any of its assets, and that the plaintiff was not a joint venturer or partner with Bell in its operations. The Court finds that the plaintiff was an employee of Bell and that he received the payment of $555,000 in 1965 as compensation for services rendered to Bell. The Court agrees with the Commissioner that the $555,000 payment is not entitled to treatment under the capital gain provisions of the Internal Revenue Code.

15. Further, the Court finds that the plaintiff held himself out as a consultant in the oil and gas industry in 1965 and that he is entitled to a deduction of the disputed business expenses. In this connection, the plaintiff is entitled to a refund of income taxes in the amount of $2,430.45, and assessed interest in the amount of $209.38, plus statutory interest thereon. In all other respects, the claims of the plaintiff are denied.

Conclusions of Law

1. The Court has juisdiction of this action and the parties under Section 1326(a)(1), 28 U.S.C.

[1] 2. The capital gains provision of the Internal Revenue Code of 1954 is an alternative tax computation available to taxpayers only with respect to income derived from the sale or exchange of a capital asset. Section 1201, Internal Revenue Code of 1954. The basic requirements for reporting income as capital gain are that there be a "sale or exchange" of a "capital asset" in which the taxpayer has an investment. Commissioner v. Gillette Motor Transport, Inc. 364 U.S. 130 [5 AFTR 2d 1770] (C.A. 5, 1960); Holt v. Commissioner, 303 F. 2d 687 [9 AFTR 2d 1513] (C.A. 9, 1962). The burden rests with the taxpayer who seeks to bring himself within the statutory provision permitting capital gains treatment. Spangler v. Commissioner, 323 F. 2d 913 [12 AFTR 2d 5831] (C.A. 9, 1963).

In the instant case, plaintiff has failed to sustain his burden of proof that he owns such an interest in either Bell or its assets as to entitle him to treat the profits from the sale of the assets as capital gains.

3. Compensation for services rendered constitutes ordinary income under Section 61(a) of the Internal Revenue Code of 1954. Pounds v. United States, 372 F. 2d 342 [19 AFTR 2d 514] (C.A. 5, 1967). A lump

sum payment made as a substitute for what would otherwise be ordinary income remains ordinary income. Specifically, lump sums received in satisfaction of what is in reality compensation under an employment contract constitutes ordinary income. Clerk v. United States, 341 F. 2d 691 [15 AFTR 2d 313] (C.A. 9, 1965); Wiseman v. Halliburton Oil Well Cementing Co., 301 F. 2d 654 [9 AFTR 2d 1389) (C.A. 10, 1962); Bisbee-Baldwin Corp. v. Tomlinson, 320 F. 2d 929 [12 AFTR 2d 5025] (C.A. 5, 1963); United States v. Eidson, 310 F. 2d 111 [10 AFTR 2d 6034] (C.A. 5, 1962); General Artists Corp. v. Commissioner, 205 F. 2d 360 [44 AFTR 72] (C.A. 2, 1953); Copeland v. Ratterree, [52 AFTR 1309] 57-2 U.S.T.C., par. 9895 (N.D. N.Y., July 23, 1957).

4. The terms of the contract control the tax effect to be accorded the transaction, and the taxpayer is bound by the form in which he casts his transactions. Commissioner v. Danielson, 378 F. 2d 771 [19 AFTR 2d 1356] (C.A. 3, 1967), cert. denied, 389 U.S. 858 (1967).

The Court finds that there is no ambiguity in the contracts between Bell and plaintiff. Terms of the 1941 contract of employment, as well as the previous contracts between Bell and plaintiff, set out the relationship between Bell and plaintiff as that of employer and employee, respectively. Furthermore, the subject employment contracts clearly characterized the funds advanced by plaintiff to Bell as indebtedness, not capital.

5. The Court concludes that the payment from Bell to plaintiff in the amount of $555,000 in 1965 represented compensation for services rendered and, as such, the payment is taxable as ordinary income.

6. The Court concludes that plaintiff is entitled to deduct expenses incurred by him in 1965 in connection with his business as an oil and gas consultant under Section 162 of the Internal Revenue Code of 1954.

7. Any finding of fact which is deemed to be a conclusion of law is hereby adopted as a conclusion of law.

8. Judgment will be entered accordingly.